Taxation of 457(f) Defined Benefit Plans

Once the risk of forfeiture lapses the participant is taxed on the value of his account. For a Defined Benefit (DB) Plan, the value of the account is considered the present value of the future stream of payments to be made. The example below assumes that there is no vesting before retirement, with 100% vesting at retirement. The participant will pay an initial tax on the present value (PV) of the stream of payments upon full vesting at retirement. In addition, each payment received will be taxed under the Annuity Rules of IRS Section 72, which allows an exclusion ratio to be calculated, which will exclude a portion of each payment to be received from tax. This in essence, allows the participant to recover the PV of payments that was taxed in the year of retirement over the payment period.

Retirement Benefit: $100,000 for 3 years
Tax Bracket: 28 %
Discount Rate: 6%

PV of $100,000 for 3 years @ 6%: 283,339
Investment in the Contract (Amount you initially pay tax on) = 283,339
Expected Return: = 100,000 x 3 = 300,000
Exclusion Ratio: = 283,339/300,000 = .944
94.4% of each periodic payment will be excluded from tax

First year tax paid	
.28 x 283,339 =	79,335
.28 x (1-.944) x 100,000 =	1,568
TOTAL:	80,903

Second and third year tax paid	
28 x (1-.944) x 100,000 =	1,568
Total tax paid:	84,039

Note that the total tax paid (84,039) is 28% of 300,000 (total payments).
Section 72 changes the incidence of the tax payments, and not the amount due.